

Deducting Casualty Losses

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Taxpayers can deduct qualified casualty and theft losses for both personal and business property. Generally, losses of personal use property are claimed as an itemized deduction on schedule A, while losses on business use property may be deducted elsewhere on the return, depending on the type of property.

Usually, the deduction is claimed for the tax year in which the loss occurred. However, in a national disaster area declared by the President, taxpayers have the option of amending the prior year return instead to allow them to receive a refund before the next year's filing season. If you have the option of amending the prior year's return or claiming the loss for the current year, your individual tax situation will determine which option is more advantageous to you.

What is a Casualty Loss?

The IRS defines a casualty (or theft) loss as loss due to an event that is:

- Sudden
- Unexpected
- Unusual

Events like *fires*, earthquakes, floods, and thefts generally meet these criteria.

How much is my loss?

The amount of the loss is calculated as follows:

- 1) Determine what's called the *basis* in the property. Generally, the basis is your purchase price plus any improvements you've made. If the property was received as a gift or inheritance, the calculations are different – consult your tax advisor.
- 2) Determine the decrease in the *fair market value* of the property. The decrease is the difference between the value of the property before the loss and any remaining value after the loss. The IRS recommends using a "competent appraiser" to determine the value of the property before and after a loss. In some cases, the cost of repairing the property can be used to determine the decrease in fair market value.

For example, a house with a fair market value of \$220,000 was destroyed by fire. If the land after the loss is worth \$70,000, the decrease in value would be \$150,000 – the difference in value before and after the loss.

- 3) After determining these two numbers, the loss you can claim is the *lower* of the two.

For business or income producing property that is completely destroyed, only the difference between the basis in the asset and any salvage value is considered (the decrease in the fair market value is not used).

Generally losses are computed separately for each item. But, for personal-use real property, taxpayers can compute losses for the entire property as a single item.

- 4) The loss is then reduced by any insurance proceeds or other reimbursements that you receive or are entitled to – *even if you don't file a claim or haven't received a settlement yet* (you can amend the return if the actual settlement differs from what you anticipated).

Cash gifts or other support not specifically designated for the repair or replacement of the property (general disaster relief, insurance payments for living expenses, etc.) are not considered

reimbursement, even if you use the proceeds to repair or replace your property. Non-cash disaster relief assistance (food, medical supplies, etc.) is also generally excluded from the calculations, unless it replaces lost or destroyed property.

How much can I deduct?

Casualty losses on business property are allowed in full. However, if the property was used to perform services as an employee, it will remain subject to the 2% of adjusted gross income limitation on work-related and other miscellaneous expenses. Losses on personal property are reduced by two amounts:

- 1) The total loss from each event is reduced by \$100 for each person filing a claim (married couples filing jointly are treated as one person for this)
- 2) The total losses from all events are further reduced by 10% of your adjusted gross income.
- 3) Since personal losses are claimed as itemized deductions, you may see no tax benefit from a deductible loss if the total of all your itemized deductions is less than your allowed standard deduction. Some business losses are taken directly on the appropriate schedule, rather than as an itemized deduction.

Example: Jo's car, with a fair market value of \$8,250 was destroyed in the Witch fire. There was no insurance reimbursement, and the fair market value after the fire was \$250 (scrap value). Because the reduction in the fair market value is less than her *basis* (she paid \$16,000 for the car when it was new), she has an \$8,000 loss. Her adjusted gross income is \$60,000. Her deductible loss is:

\$8,000 less
\$100 reduction equals
\$7,900 less
\$6,000 (10% of her \$60,000 adjusted gross income) equals a
\$1,900 deductible loss

She had \$5,000 in other itemized deductions, so her total itemized deductions are \$6,900. This reduces her taxable income \$1,550 more than the 2007 standard deduction of \$5,350.

Taxable income from a casualty loss

Strange as it sounds, a casualty loss may create taxable income for some taxpayers. If the amount of reimbursement is greater than your basis in the asset, the loss may be treated as a sale of the asset for the amount of reimbursement, creating taxable gains. However, depending on the asset or the type of loss, you may be able to exclude or defer the gain.

You can also have taxable income if insurance payments for your living expenses exceed the increase in your living expenses after a casualty. Qualified disaster relief payments in Presidentially declared national disaster areas are *not* taxable.

How to claim a loss

Personal casualty losses are calculated on *Form 4684*, and reported on *Schedule A*. Since you will have to itemize deductions to claim the loss, you will also have to file a long form (*form 1040*). Some business casualty losses are claimed on these forms as well, but others are claimed elsewhere -- consult your tax advisor or www.irs.gov for the appropriate treatment.

If you qualify and elect to claim a loss on the prior year's return, you will file form *1040X* (amended return) as well as the forms above. You will probably also amend your California tax return, using California form *540X*.

Where to get more information

For this and any other tax issues, please consult your tax advisor.

The IRS provides a workbook (Publication 584 for personal losses and 584-B for business losses) as well as Publication 547 with information on claiming casualty and theft losses. IRS forms and publications are available at www.irs.gov, or can be ordered at 1-800-829-3676.

California tax forms can be found on the Franchise Tax Board website www.ftb.ca.gov, or ordered at 1-800-338-0505 (the three digit code for form 540X is 908).

This is intended as general information on casualty and theft losses. Every situation is unique; for information on how this applies to your particular situation, please consult your tax advisor.